UNITED STATES DISTRICT COURT

FOR THE CENTRAL DISTRICT OF CALIFORNIA

In Re FIRST ALLIANCE MORTGAGE COMPANY, et al., **Related Debtors** _____ **FRANK and NICOLENA AIELLO, MICHAEL and BARBARA AUSTIN, PAUL and LENORE CARABETTA; GEORGE and JOSEPHINE JEROLEMON; individually and on behalf of all others similarly situated,** **Plaintiffs,** **v.** **BRIAN CHISICK; LEHMAN COMMERCIAL PAPER, INC.; LEHMAN BROTHERS, INC.,** **Defendants.** _____	**CASE NO. SA CV 01-971 DOC** **ORDER DENYING DEFENDANT'S MOTIONS TO DISMISS AND TO COMPEL ARBITRATION**

Before the Court is Defendant Brian Chisick's motions to dismiss and compel arbitration of the claims against him. After reviewing the moving, opposing, and replying papers, and for the reasons set forth below, the Court DENIES the motions.

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I.

BACKGROUND

Defendants First Alliance Mortgage Company of California, First Alliance Corporation of Delaware, First Alliance Mortgage Company of Minnesota, and First Alliance Portfolio Services of Nevada (collectively, First Alliance) have been in the business of subprime mortgage lending since 1971. First Alliance's customers generally were borrowers who would have had difficulty obtaining loans from conventional sources because of poor credit ratings or insufficient credit histories. The loans, many of which were refinancings by homeowners who had developed significant equity in their homes, typically were secured by the borrowers' first mortgages. As of 1999, First Alliance or affiliated entities were licensed to operate in eighteen states and the District of Columbia and serviced nearly $900 million in loans.

Chisick is the founder and Chief Executive Officer of First Alliance. In recent years, a number of lawsuits were filed against First Alliance, alleging that its lending practices violated various consumer protection laws. First Alliance's lending practices became the focus of national publicity when the *New York Times* and the television program "20/20" carried stories that exposed the company's allegedly deceptive practices and highlighted the number of lawsuits that had been filed against it. A few days later, on March 23, 2000, First Alliance filed a voluntary petition under Chapter 11 of the Bankruptcy Code, 11 U.S.C. §§ 101-1330, because of the costs associated with the growing number of lawsuits.

Class Plaintiffs brought this Adversary Proceeding for Equitable Subordination. This Court withdrew the reference to the bankruptcy court. Chisick now brings the instant motions.

II.

MOTION TO DISMISS

A. Legal Standard

Under Federal Rule of Civil Procedure 12(b)(6), a complaint can be dismissed when the plaintiff's allegations fail to state a claim upon which relief can be granted. The court must construe the complaint liberally, and dismissal should not be granted unless "it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him

to relief." *Conley v. Gibson*, 355 U.S. 41, 45-46, 78 S. Ct. 99, 101-02, 2 L. Ed. 2d 80 (1957); *see Balistreri v. Pacifica Police Dep't*, 901 F.2d 696, 699 (9th Cir. 1990) (stating that a complaint should be dismissed only when it lacks a "cognizable legal theory" or sufficient facts to support a cognizable legal theory). The court must accept as true all factual allegations in the complaint and must draw all reasonable inferences from those allegations, construing the complaint in the light most favorable to the plaintiff. *Westlands Water Dist. v. Firebaugh Canal*, 10 F.3d 667, 670 (9th Cir. 1993); *Balistreri*, 901 F.2d at 699; *NL Indus., Inc. v. Kaplan*, 792 F.2d 896, 898 (9th Cir. 1986). Dismissal without leave to amend is appropriate only when the court is satisfied that the deficiencies of the complaint could not possibly be cured by amendment. *Chang v. Chen*, 80 F.3d 1293, 1296 (9th Cir. 1996); *Noll v. Carlson*, 809 F.2d 1446, 1448 (9th Cir. 1987).

B. Discussion

A claim for equitable subordination pursuant to 11 U.S.C. § 510(c) requires a showing that: "(1) that the claimant engaged in some type of inequitable conduct, (2) that the misconduct injured creditors or conferred unfair advantage on the claimant, and (3) that subordination would not be inconsistent with the Bankruptcy Code." *Feder v. Lazar (In re Lazar)*, 83 F.3d 306, 309 (9th Cir. 1996). Generally, there are three factual situations in which an equitable subordination claim may be had: "(1) when a fiduciary of the debtor misuses his position to the disadvantage of other creditors; (2) when a third party controls the debtor to the disadvantage of other creditors; and (3) when a third party actually defrauds other creditors." *United States Abatement Corp. v. Mobil Exploration & Producing, U.S., Inc. (In re United States Abatement Corp.)*, 39 F.3d 556, 561 (5th Cir. 1994). Here, Class Plaintiffs state a claim against Chisick for controlling the debtor to the disadvantage of other creditors. Class Plaintiffs allege that Chisick was the founder, owner, chairman, and President of First Alliance, and that Chisick designed and implemented First Alliance's allegedly fraudulent lending scheme.

A claim for equitable subordination is encompasses traditional common law principles of equity. *See* S. Rep. No. 989, 95th Cong., 2d Sess., at 74, reprinted in 1978 U.S.C.C.A.N. 5787; *accord Fabricators, Inc. v. Technical Fabricators, Inc. (In re Fabricators, Inc.)*, 926 F.2d. 1458,

1464 (5th Cir.1991); The Fifth Circuit, in *United States Abatement Corp, supra*, indicated that although there would be no equitable subordination when an a controlling party exercises the debtor's legal rights, when a party uses their control to perpetrate a fraudulent scheme, principles of equity require that he be placed last in line to receive the assets of the estate.[1]

Accordingly, Chisick's motion to dismiss the Class Plaintiffs' claim for equitable subordination is DENIED.

III.

MOTION TO COMPEL

Chisick seeks to compel arbitration of the class claims against him. In cases governed by the Federal Arbitration Act (FAA) of 1947, federal courts are empowered to compel arbitration and to stay actions arising out of disputes that are subject to an arbitration agreement. 9 U.S.C. § 3. A party aggrieved by another party's failure to submit a dispute to arbitration may petition a district court for an order compelling arbitration. 9 U.S.C. § 4.

However, arbitration is not favored in the bankruptcy context. "The decision to compel or deny arbitration is discretionary with the bankruptcy judge. A bankruptcy judge does not abuse his discretion when he refuses to compel arbitration where the determination in such a proceeding would affect the amount, existence and priority of claims to be paid out of the general funds and, thus, involve the interests of other creditors." *In re F & T Contractors, Inc.*, 649 F.2d 1229, 1232 (6th Cir. 1981).[2]

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[1] At oral argument, Chisick suggests that to be liable in a claim for equitable subordination, an insider or controller must intend to perpetrate a fraud. The complaint alleges that Chisick "developed the Track and masterminded the Company's [First Alliance] fraudulent lending practices." First Am. Compl. ¶ 100.A. This appears to be a sufficient allegation of Chisick's intent to use his position as a First Alliance insider to perpetrate a fraud on the creditor/borrowers represented by the proposed class.

[2] For further explanation of the tensions between the Federal Arbitration Act and the Bankruptcy Code, *see* Mette H. Kurth, Comment, *An Unstoppable Mandate and an Immovable Policy: the Arbitration Act and the Bankruptcy Code Collide*, 43 U.C.L.A. L. Rev. 999 (1996) (suggesting that judicial discretion for applying the Federal Arbitration Act be exercised unless the adversary proceeding is brought by the debtor in a non-core

Here, arbitration would undermine the goals of the bankruptcy code and negatively affect the creditors of the First Alliance estate.[3] Litigation of the most substantial claims against the First Alliance are set to be tried by this Court in April. Throughout the Court's administration of this case, it has sought to provide a single forum for adjudication of the claims, in order to facilitate either a global settlement or a speedy adjudication of the claims. This assures that the estate's assets are not dissipated, frustrating the interests of First Alliance's creditors and interest-holders.[4] At the debtor's request, the Court has found several of the individual defendants to be subject to this Court's jurisdiction, and has ordered them brought into this matter. Separating Mr. Chisick now to arbitration would frustrate those purposes and likely require the involvement of many of the same witnesses and parties, including the debtors, further dissipating the estate's assets. This would frustrate the purpose of the bankruptcy laws of preserving the assets of the estate.

Furthermore, it does not appear that a claim for equitable subordination is subject to arbitration. Such a claim is a core proceeding, as it is central to the Court's equitable power to administer the assets of the estate. 28 U.S.C. § 157(b)2(A). Arbitration could therefore not be had when it infringes on the heart of a bankruptcy court's jurisdiction.

Accordingly, Chisick's motion to compel arbitration is DENIED.

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matter).

[3] In his motion, Chisick requests the Court to stay the entirety of the action pending the completion of the arbitration. This is a rather large case that includes enforcement actions against First Alliance and several individuals brought by various states, the Federal Trade Commission, and several private claimants. At oral argument, Chisick indicated that he did not intend to stay the actions against First Alliance.

[4] Chisick should consider the speedy resolution of this matter a benefit to him as well, not merely for the reduction in time and fees that will result, but because, as the major interest-holder in First Alliance, he stands to receive the lion's share of the estate if the litigation fails.

IV.

CONCLUSION

For the foregoing reasons, Defendant Chisick's motions to dismiss and to compel arbitration are DENIED.

IT IS SO ORDERED.

DATED: JANUARY 9, 2002

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DAVID O. CARTER
United States District Judge